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SUBJECT: BULGARIA - OVERHEATING ECONOMY OR JUST GETTING WARMED UP?

**¶1. (U) SUMMARY:** Strong domestic consumption in Bulgaria has sparked a large trade deficit and led to a current-account (CA) deficit of 15.8% in 2006. International analysts have warned that Bulgaria's growing external deficits render its economy vulnerable to exogenous shocks. While booming domestic credit has supplied money for an under-capitalized economy, it also has heated up certain sectors of the economy, such as the real estate market, while at the same time increasing debt levels. In the absence of effective monetary authority given Bulgaria's currency-board arrangement, tight fiscal policies remain the principal working instrument to control public wages, inflation and further deterioration of the external sector.

END OF SUMMARY

#### INTERNATIONAL ANALYSTS RING THE BELL

2 (U) According to a recent World Bank report, in some countries--most notably Latvia but also the other Baltic countries, Bulgaria, and Romania--booming domestic demand is leading to overheating and current growth rates are unlikely to be sustainable. Danske Bank earlier said it is expecting a less optimistic outlook of the Bulgarian and Romanian economies by international credit agencies due to a lack of progress in EU-related reforms and "continued rise in the external imbalances." The IMF has similarly drawn attention to Bulgaria's rising external debt, which reached around 80 percent of GDP last year.

#### EU-PHORIA DRIVES HIGH GROWTH AND CURRENT ACCOUNT DEFICIT

**¶3. (U)** Euphoria related to Bulgaria's EU accession has led to high and steady economic growth--over 5 percent on average in the last 7 years--driven by buoyant consumption and investment activity. While the strong domestic demand reflected expectations for deeper EU integration and rising incomes, it also caused a large expansion of trade and current account (CA) gaps. The CA deficit tripled over the last three years to 15.8 percent of GDP in 2006, while the trade gap rose to 21.5 percent of GDP. The first quarter of 2007 reconfirmed this negative trend with CA deficit growth of 5.6 percent of GDP. The deficit in April grew even further to 8 percent of GDP for the quarter. Government officials and some analysts argue that a new EU requirement has led to a notable underreporting of exports.

#### CA DEFICIT PROJECTED TO GROW

**¶4. (U)** The IMF projected further growth of the CA deficit to 16.6 percent of GDP this year, slowing to 16.2 percent in 2008. Finance Minister Oresharski was less optimistic, saying the deficit this year might grow to 18 percent of GDP. Local media speculated that Oresharski, who is known for his conservative fiscal positions, might have intentionally over-stated the figure in an effort to stem some ministers' demands for increased budget spending.

## LARGE DEFICITS FED BY MORE FOREIGN INVESTMENT

**15.** (U) As is typical for an open and undercapitalized economy, Bulgaria's growing CA deficits have been increasingly financed by outside money and capital. This has been facilitated by a liberalized investment regime and higher investor confidence in the run-up to EU membership. Foreign direct investments (FDI) grew to a record high in 2006, adding to a strong financial account that managed to cover last year's CA deficit (103.2 percent). The growing foreign investments help build up a stock of investment goods--a third of last year's imports--which while exacerbating the trade balance, is helping the higher capitalization and more sustainable growth of the economy. According to analysts from the Institute for International Finances, based in Washington, D.C., new capital growth has been too strong in recent years--over 18 percent on average in the last three years--and the need for some "cooling" has already arrived.

## OVERHEATING OF REAL ESTATE - QUITE STRONG AND RISING

**16.** (U) The level of corporate and household credit reached 39.6 percent annual growth in April. This concerns the central bank, which removed administrative barriers to credit growth at the beginning of this year and has no intention to re-impose them. The increased money supply created more liquidity and strong inflationary potential in some sectors of the economy, most notably real estate. While consumer prices saw an average annual increase of 7.3% in 2006, housing prices rose 14.7 percent. Prices in the real estate market are likely to surge as demand for housing remains stable, while there is ample room for mortgage loans to grow. This could lead to the accumulation of new household debt, which has grown 40.1 percent year-on-year in the first quarter of 2007. The level of corporate debt is also raising concern, as it increased to 49.1 percent year-on-year in May reflecting local firms' increased needs for financing their investment activities.

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